

## Chapter 302

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# PROFITABILITY

### Introduction

The adequacy of a corporate credit union's (corporate) earnings in relation to its capital accumulation strategies should be a major area of evaluation during the ongoing supervisory process. Each corporate's earnings performance must be evaluated in relation to its current capital position, financial and operational risk exposures, complexity of operations, and its strategies and business plans. The ongoing accumulation and maintenance of adequate capital should be the examiner's major focus when making an assessment as to the adequacy of each corporate's earnings performance.

The review of the corporate's earnings and financial condition is a continuing process. The pre-examination analysis and scoping process should identify any existing or potential problem areas requiring attention. A comprehensive on-site analysis substantiates and assesses current and prospective earnings. A well-performed analysis not only provides an understanding of the corporate's operations and earnings capability, but also identifies matters of existing or potential concern. Thus, the analysis can be used to facilitate corrective action that may avert problems or prevent existing problems from deteriorating.

The examiner should maintain a sense of balance when analyzing financial statements, avoiding undue precision or spending excessive time on immaterial amounts and/or items. Most importantly, the examiner should constantly maintain a sense of examination objectives. Since earnings, over time, reflect the corporate's overall financial condition, the examiner should know the extent of existing or potential problems outside the purview of the earnings/profitability analysis. The examiner must maintain a constant flow of communication with individuals working on other examination areas in order to affect a cohesive and comprehensive review.

Finally, reporting errors, incomplete information, and deficient accounting information may hinder or prevent an accurate evaluation of the corporate's operations. A thorough analysis depends on

accurate, reliable information and is an extension of reviews of the corporate's financial records and reports (i.e., financial statements, call reports, budget variance reports, board reports).

### **Relationship of Earnings to Capital Accumulation and Risk**

Profitability must be evaluated in relation to each corporate's overall capital accumulation needs and risk exposures. Corporates that exhibit adequate levels of capital in relation to risk exposure and risk management practices will not necessarily require the same earnings performance as those corporates which have a low capital level in relation to regulatory requirements and risk activities. The examiner must keep this relationship in mind when evaluating the adequacy of earnings performance.

Each corporate's earnings must be evaluated with the following objectives in mind:

1. Determine earnings are sufficient to accumulate adequate capital levels; and
2. Determine whether the stability and mix of earnings components is appropriate to continue to accumulate or maintain adequate capital levels.

### **Components of Earnings**

In order to obtain a complete and accurate understanding of a corporate's operations, it is essential to know the operating strategy of the institution. The operating strategy is identified in the corporate's strategic business plans and can be identified by determining major revenue and funding sources. Earnings components include interest income and expense, fee income, operating expenses, other income and expenses (operating or non-operating), etc.

Interest Income - Interest income consists of interest earned on loans and investments. The major contributor to interest income within a corporate is normally the investment portfolio.

Interest Expense - Interest expense consists of the corporate's cost of funding operations. Interest expense in a corporate will be realized

through dividends on shares, share certificates, member capital accounts, and interest on borrowings (i.e., loans, reverse repos, commercial paper). For GAAP and regulatory reporting, dividends on paid-in capital accounts are not included in interest expense, but rather as a distribution of equity.

Net Interest Income (NII) - NII is interest income minus interest expense. NII is normally the primary source of income for a corporate and a key indicator of earnings performance and stability. This measure makes no adjustment for non-earning assets or liabilities that bear no explicit interest cost.

Net Interest Margin (NIM) - NII is called the NIM when expressed as an annualized percent of moving daily average net assets (DANA). A corporate can maximize its NIM by effectively allocating resources among earning and non-earning assets, maintaining low levels of non-performing assets, providing adequate funding through the lowest-cost mix of funds, and maintaining a strong capital position. In a volatile interest rate environment, large changes in NIM are associated with high interest rate risk exposures and possibly with weak risk management.

Net Interest Position (NIP) - A corporate's NIP is the difference between interest earning assets and interest paying liabilities. A shrinking NIP may indicate a weakening balance sheet and greater reliance on margins on products and investments for continued profitability. A negative NIP is considered a more serious weakness since it indicates interest-costing liabilities are financing non-interest-earning assets. Generally, corporates have sound NIPs due to low levels of non-earning assets. Shrinking NIPs should be reviewed by the examiner using a cost/benefit analysis of non-earning asset expenditures (i.e., will fee income and member service be enhanced).

Net Interest Spread - Net interest spread is the weighted interest rate received on average earning assets less the weighted interest rate paid on average liabilities.

Non-Interest Income - All other income.

Non-Interest Expense - Non-interest expenses are the costs of operating the corporate (i.e., operating expenses). A reduction in non-interest expenses will increase core earnings, net income, and market value. A managed level of operating expenses also allows the corporate greater flexibility with respect to managing net interest margin and levels of credit and interest rate risk.

### **Return on Assets and Equity**

Return on Assets - Return on assets is net income divided by average assets. Traditionally, return on assets is the primary measure of a corporate's profitability. The examiner should review the level and trend of this ratio in relation to capital strength and financial and operational risks.

Return on Equity - Return on equity is net income divided by average equity. The return on equity is normally a ratio used by investors in the capital markets to evaluate investment options. Return on equity can be used to measure management's effectiveness in utilizing and accumulating capital to ensure a strong net economic value and the long-term viability of the institution.

### **Evaluation of Earnings**

An aggregate evaluation of all earnings components should be performed in relation to stability and trends.

Stability - The quality, composition, and consistency of income and expense flows should be evaluated relative to internal factors such as credit, interest rate, and operational risks, and external factors (i.e., general economic or competitive forces). The stability of earnings under different economic and competitive scenarios is critical in setting, attaining, and maintaining the capital accumulation objectives of the corporate.

Some corporates have positioned themselves as major providers of "back office" and correspondent services. The stability of service fees depends upon the proper management and promotion of these products.

Earning Trends - The general direction of a corporate's earnings relative to previous time periods.

Through trend analysis the examiner should identify and investigate both adverse and positive trends within the corporate's earnings. Earnings trends must be viewed in relation to the capital accumulation and risk management objectives of the corporate. Trends must also be viewed in conjunction with macro-economic conditions within the financial markets as these conditions affect the entire System.

### **Analytical Techniques**

Earnings analysis involves the review of financial data on a period-to-period basis in an effort to substantiate the reasonableness of financial performance without requiring a systematic review of transactions.

There are three primary components to performing a thorough trend analysis. These components are:

1. Twelve to twenty-four months of financial information for analysis;
2. Sound judgment in determining the materiality of variances; and
3. Volume-to-rate variance analysis.

The use of twelve or more months of data provides an understanding of what will likely be normal changes in the data. Given the seasonal funds flow indigenous to corporates, at least twelve months of data must be observed in order to make an assessment as to any irregular changes or trends. By comparing variances over several accounting periods, patterns of change emerge that can be used to identify any unusual changes in current periods. Another benefit is that an examiner can identify a change that may warrant further review.

The use of sound judgment in assessing the materiality of a variance in the data cannot be over-stressed. Examiners must use professional judgment when evaluating the change, but must also remember that business is dynamic and change is inevitable. Only those variances that are not reasonable or are of a sufficient magnitude to justify additional examination procedures should be pursued. Such variances include cyclical and seasonal factors, changes in accounting practices

and operating strategies. Positive or adverse trends should be identified and explained, so the findings support the overall evaluation.

Ratio Analysis - Ratio analysis is the method of comparing a figure or group of figures in a set of financial statements to another figure or group of figures within the same financial statements. It is predicated on the assumption that there are meaningful relationships between different asset, liability, net worth, net income, and expense accounts.

Numerous standardized ratios have been developed for analyzing financial statements. The more commonly used ratios include:

1. Capital divided by moving DANA (Capital Ratio);
2. Reserves and undivided earnings divided by moving DANA (Retained Earnings Ratio);
3. Gross interest income divided by moving DANA;
4. Cost of funds divided by moving DANA;
5. Net interest income divided by moving DANA;
6. Operating expenses divided by moving DANA; and
7. Net income divided by moving DANA.

For additional discussion on analytical techniques, refer to Chapter 2, Total Analysis, in the National Credit Union Administration, Examiner's Guide.

### **Budgeting and Performance Monitoring**

The examiner should obtain a copy of the budget including projected revenues, expenses, and underlying assumptions (i.e., asset growth, sensitivity). An evaluation of this budget would include comparing:

1. Projections with prior period results;
2. Projections with actual results for the same period;
3. Projected return on assets and return on equity with prior period results;
4. Projected yields for major earning assets with prior period yields;
5. Projected operating expenses as a percentage of assets and revenues with prior period data; and

6. Projected goals and assumptions with trends and market conditions.

The key to evaluating the budget is to understand the validity of the underlying assumptions and the probability of projected goals. Prior data does not provide meaningful information if the entire focus of the corporate is changing.

Controlling business risks is one of the primary responsibilities of management. The types of risk assumed by the corporate, and how well management controls those risks, is reflected in the balance sheet and income statement. By analyzing the balance sheet and operating results in relation to projected goals, the examiner can determine whether management's policies benefit or adversely impact the corporate.

The examiner must determine the effectiveness of management's profit planning and control function. The examiner should not only make an assessment as to the reasonableness of the results of operations and budgeted goals and objectives, but should also determine that management has an effective budget review and reporting process in place.

### **Product Line Profitability**

In addition to making an assessment as to the corporate's overall earnings performance, the examiner should also determine that management has effective processes in place to monitor the profitability of individual product offerings. Management should be performing a risk/return evaluation on each major product offering.

Periodic product profitability monitoring and reporting will provide management with valuable information regarding the effectiveness with which products are being offered to their members, and the competitive demand for those products. Maintaining and monitoring the results of individual product lines in relation to projected goals will provide a clear depiction as to where improvements may need to be made in order to benefit the overall earnings and competitive position of the corporate.

The examiner should determine that an effective cost accounting process is in place that segregates revenue and expense by individual product line. The system should provide a reasonable allocation method for corporate overhead and shared expenditures. Individual product profitability reporting should be completed on at least a quarterly basis, with formal reports made to the ALCO or board at least annually.

### **Recordkeeping and Reporting**

Complete and accurate records and reports are essential for a corporate's board and management in making informed decisions and in clearly understanding and supporting transactions. The corporate must also have policies, procedures, and controls to ensure financial reports and records are properly maintained. Inaccurate, incomplete, or unreliable information jeopardizes the safety and soundness of the corporate in that unidentified or undisclosed problems could prevent or delay corrective action and undermine the viability of the corporate.

NCUA must have reliable data so it can assess and monitor a corporate's financial condition and activities. It is imperative the corporate have adequate procedures and controls in place over the compilation of data used to prepare the NCUA 5310 Call Report (5310). Examiners will discuss these controls with management. Review of corporate's books and records, internal reports, and 5310 reports are necessary if NCUA is to rely on the corporate's records for information throughout the examination, supervision, and monitoring process.



**Examination Objectives**

The examiner will address the following main examination objectives during the review of the corporate's earnings performance and profit planning process:

1. Determine and evaluate the corporate's policies, procedures, and controls for maintaining accurate income and expense reports and records;
2. Test the accuracy of balance sheet and income and expense data reported on monthly 5310 reports;
3. Evaluate the corporate's capital and earnings objectives and strategies;
4. Identify, evaluate and explain positive and negative income and expense trends;
5. Assess the prospective effect on earnings as a result of any changes in the activities or strategies of the corporate; and
6. Evaluate management's budgeting and reporting process to determine that profit planning and control is being administered in an effective fashion to identify and achieve earnings and capital accumulation objectives.

**Examination Procedures**

See Corporate Examination Procedures - Profitability

**Examination Questionnaire**

See Corporate Examination Questionnaire - Profitability

**References**

1. Office of Thrift Supervision, Regulatory Handbook - Thrift Activities, Volume II; and
2. National Credit Union Administration, Examiner's Guide, Chapter 2, Total Analysis Process.